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PRIME MINISTER

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The Treasury and Civil Service have agreed to the following Report

GOVERNMENT'S ECONOMIC POLICY : AUTUMN REVIEW

Introduction

1. This report updates the Committee's Second Report,[1] which examined some of the principal assumptions and forecasts behind the Budget and the Government's Medium-Term Financial Strategy and recorded the Committee's reservations and anxieties. We concentrate here on developments in the economy in the eight months since the Budget and on the prospects for 1981 in the light of the policy changes announced by the Chancellor of the Exchequer on 24 November, and of the Treasury's latest forecasts. The Government's economic strategy in the longer term will be discussed in the separate report we will be making on monetary policy early next year. We took oral evidence from Treasury officials on 1st December and benefited from useful papers from the Economist Intelligence Unit[2] and the National Institute of Economic and Social Research.[3] Once more we are indebted in the preparation of this report to our advisers, Dr Alan Budd, Dr Paul Neild and Mr Terry Ward.

2. We fully understand that the Government's policy is intended to achieve its objectives in the medium term; but that does not mean that the short term can be ignored. The medium term strategy must take the possible short-term costs into account. It is possible, indeed, that the short-term costs are so high that they could endanger the achievement of the longer term objectives. Also, the credibility of the medium-term strategy must depend on what is happening to the chosen instruments of policy and to the economy itself in the short term. Divergence from the path laid down on the scale witnessed in past months must jeopardise the credibility of the strategy, when we are told that the strategy itself depends upon changing people's expectations.

Recent Developments and Prospects for 1981

(a) Gross Domestic Product and the components of demand

3. Figures for 1980 are still incomplete. There is a preliminary estimate for GDP (the output estimate) and for consumers' expenditure for the third quarter of the year. There are figures for exports and imports of goods for the third quarter and there are provisional figures for investment and stockbuilding by the manufacturing and distributive industries for the same period. It is thus too early to forecast with any certainty the outturn for the year as a whole.

4. The Treasury's most recent forecasts are shown in Table 1 where they are also compared with the forecasts published with the Budget. If 1980 proceeds as the Treasury now expects, the expected fall in GDP will be 3%; close to the 2½% fall originally forecast by the Treasury in the Financial Statement and Budget Report for 1980-81. In general, the forecasts of

the components of demand fall within the average margins of error. There are however two cases in which the error is particularly large - stockbuilding and imports. The two are related. Companies have run down stocks in response to the financial squeeze and the general economic climate and in particular have reduced imports. Table 1 also illustrates the Treasury's point[4] that, so far, the recession has been caused by domestic factors rather than external factors in that the growth of UK export markets has been relatively buoyant although the UK's share of those markets has fallen this year.

5. It will be noted that the volume of General Government expenditure on goods and services has not fallen as much as forecast earlier. It is the only element of domestic demand proving to be higher than had been forecast.

6. The forecast that GDP will fall by 1½ percent in 1981 as a whole implies that output will start rising early in the year. (The Treasury's forecasts by half years show marginal increases in the first and second half of 1981.) In their evidence to us on December 1st, Treasury officials confirmed this view but were reluctant to state precisely when they expected the turn in the economy to occur.[5] (In July last Treasury officials were predicting an upturn later on in 1981). The major part of this projected recovery is based on the expected movement in stockbuilding between the second half of 1980 and the first half of 1981.

7. So far there is no direct evidence to support the Treasury's view that there has been a rapid fall in stocks in the second half of the current year. The only figures available for stockbuilding are those for manufacturing and distribution, which provide only an approximate guide to developments in the whole economy. The most recent figures here, which cover the third quarter of the year, show only a small fall in stocks. It is quite possible that stocks are falling sharply in the fourth quarter of the year, but stockbuilding is a highly volatile and ill-measured element of expenditure. Thus the listed evidence available provides a precarious foundation on which to base expectations of an early recovery in the economy. Further, the ratio of manufacturers' stocks of finished goods to production in the third quarter of the year was at least 20 per cent above the average for the previous five years[6] and would still be well above this average even if the Treasury's assumptions of rapid destocking in the fourth quarter proves valid. There thus seems room for further substantial destocking during 1981. This if it were to occur would have the effect of postponing any recovery to a considerably later date than the Treasury is forecasting.

8. The main areas of anticipated weakness next year are exports and fixed investment (both private and public) where falls of 3% and 6% respectively are foreseen. The projected drop in investment is a source of major concern for several reasons: it represents a substantial change from the time of the

Budget; the fall has important implications for employment and production; and above all it is to investment and to exports that we must look for future sustained economic growth.

(b) Manufacturing output

9. Manufacturing output in September was about 10 per cent lower than a year earlier and is now at a level not seen since the mid-1960's. The Treasury, moreover, sees no growth over the coming 12 months. The official forecast of an average 4½ per cent fall in manufacturing output for 1980 as a whole was reported in oral evidence by Treasury witnesses on 2nd April, and reaffirmed on 14th July.[7] The Treasury now expects the fall to be of 10 per cent, implying a further significant fall in the fourth quarter of 1980.

10. The expected fall in manufacturing provides striking evidence of how uneven has been the burden of the recession. On the Treasury's own figures, the expected fall in manufacturing output accounts for the entire fall in GDP. In other words, public and private services (and North Sea oil production) have been stable or have continued to grow while the manufacturing sector has experienced its most severe post-war recession. The error in the Treasury's forecast indicates the extent to which this development was unforeseen at the time of the Budget.

11. The Treasury now forecasts a fall in manufacturing output in 1980 compared with 1979 of 10 per cent and a further fall in 1981 compared with 1980 of 4 per cent. No comment of the Committee is needed to emphasise the gravity of these figures.

12. In evidence to us the Treasury stated:

> "These forecasts have prompted suggestions that, taken with the latest monthly estimates of industrial production, a sharp increase in output in the course of 1981 is implied by Treasury forecasts. This is not so".[8]

The Treasury go on to support their view by reference to figures for 1980 and 1981, half-year by half-year, which show manufacturing output much the same in 1981 as in the second half of 1980. As manufacturing output is expected to fall between the third and fourth quarters of 1980, these figures imply that the fall should come to an end fairly soon and be replaced by a rise during 1981. However, in July last, the Treasury were predicting that the turn round would not take place until later in 1981. Professor Burns modified this view in his evidence to us on 1st December when he said:

> " ... the level of output should now be getting close to the point where it ceases to fall any further, but I would not wish to be pinned down in terms of a few months when that might take place".[9]

In fact, we have seen no convincing evidence that the fall is coming to an end. It is premature to attempt a conclusion particularly bearing in mind that the Treasury believe their forecasts of manufacturing output are subject to a possible error of 4 per cent either way.

(c) The exchange rate and competitiveness

13. The Treasury's 'Economic Prospects to End 1981' notes in paragraph 6 that:

> '... there has been a large and indeed unprecedented loss of competitiveness. On the basis of relative labour costs, the level of competitiveness in 1980 is estimated to be some 40-50% less favourable than in 1978.'

In other words our unit labour costs when measured in terms of a common currency have increased by 40-50% more than those of other countries over this period. In evidence to us on December 1st the Treasury's Chief Economic Adviser, Professor Burns, said that the current level of sterling could not be explained 'in terms of the normal things which one attempts to bring to bear on this subject'[10] and in this he confirmed earlier evidence from the Bank of England. Although the economy has to some extent been shielded from the full effects of the exchange rate appreciation by the buoyancy of UK export markets, the Committee is concerned that the Treasury finds largely inexplicable a factor having a major impact on manufacturing industry in terms of its ability to compete at home and abroad. This leaves open the question whether and to what extent the exchange rate can be influenced by the authorities.

(d) Unemployment

14. Unemployment (including school leavers) in the UK was 2,163,000 in November. The seasonally adjusted figure for the UK (excluding school leavers) was 2,028,000. This total has risen by nearly 700,000 since the beginning of the year. In the past 3 months alone it has risen by over 330,000.

15. The technical assumption used in the Public Expenditure White Paper (Cmnd 7841) was that the average rate of unemployment in 1980-81 would be 1.6 million for Great Britain. This unemployment figure was defended to the Committee as plausible by the Chancellor of the Exchequer as recently as 28th July.

> "I think the position is this. The level of unemployment, if one looks at the Public Expenditure White Paper published at the same time as the budget, is assumed at a figure for Great Britain, excluding school leavers, for 1980-81 at an average 1.6 million. The current figure so adjusted is 1.536 million and is not, so far as I can judge, significantly out of line with that which was anticipated at the time of the White Paper."[11]

The assumption used for the Government Actuary's calculations for 1980-81 has now been revised upwards to an average for the year of 1.7 million[12] The fact that the November figure for unemployment (GB excluding school leavers) is already 1.9 million shows the difficulty in interpreting annual averages.

16. In their evidence on December 1st, Treasury witnesses explained that the movement in unemployment (like the movement in manufacturing output) was exceptional in relation to GDP. The rise in unemployment was to a great extent the response of companies, particularly in the manufacturing sector, to the financial squeeze that was imposed upon them. The squeeze could have been anticipated and, indeed we specifically drew attention to the possible dangers in our Second Report of last Session.[13]

17. The assumption provided by the Treasury for the Government Actuary is that unemployment will be at an average level of 2.3 million in Great Britain in the fiscal year 1981/2. Treasury witnesses on 1st December indicated that this figure was unlikely to be 'grossly misleading'.[14] The Committee were not clear what this meant. Our concerns about unemployment are reinforced by the statement of Treasury witnesses to us on 1st December that employment levels could not be expected to stop declining until late in 1981.[15]

18. It should further be noted that unemployment would be significantly higher than it currently is were it not for the various employment subsidy schemes in existence.[16] Moreover, to the extent that the recent rise in unemployment has been due to a shake-out of labour in manufacturing, any recovery in output when it comes will have a smaller than usual effect on employment prospects. In which case given the projected growth in the labour force, unemployment could go on increasing for some time to come.

(e) <u>The Corporate Sector</u>

19. Official statistics for profits tend to be subject to very large revisions. The figures for industrial and commercial profits in the first half of 1980 were both stronger than expected and at variance with alternative indicators of profitability. Company returns for the third quarter suggest a most severe fall in profits with an accompanying squeeze on liquidity.

20. Industrial profits pre-tax and before deducting stock appreciation are likely to fall significantly in nominal terms this year compared with last, judged by the evidence of company results so far published. The demand for external finance from the industrial and commercial sector is estimated by our advisers to be almost £7½ bn this year compared with a little under £6 bn last year. Moreover, these figures, though bad, would have been considerably worse had not the manufacturing sector already laid off large numbers of employees and run down stocks.

21. The recession has also hit the nationalised industries which, because of the fall in their trading profits, have been forced

to borrow significantly more than originally forecast. In our Second Report we questioned the assumptions about improvements in the nationalised industries' finances in the White Paper.[17] Developments since then show that our fears were well founded. As Professor Burns of the Treasury said in evidence to us on December 1st:

> "What is clear at this stage is that the fortunes of the nationalised industries both for this year and next year look worse than what was predicted in the public spending White Paper".[18]

22. This decline in profits has had the effect of forcing both private companies and nationalised industries to cut back planned investment, inevitably weakening the industrial base of the economy - upon which a sustained recovery in output and employment will depend.

23. In "Economic Prospects" the Treasury explains the deterioration in the company sector's financial position in terms of : "a widespread acceleration of domestic costs; a rising exchange rate; and falling profit margins". To this list could be added the fall in their sales and exceptionally high short-term interest rates. In our Second Report we commented:

> "The Committee feel that there are several factors which together tend to indicate that the corporate sector will face a substantial liquidity squeeze not only in the short-term, but probably in the medium-term as well. Amongst these, we may cite the projected slow growth in overall economic activity, high interest rates, the squeeze on profitability from the effects of a continuing strong pound (which adversely affects exports while boosting imports), and the difficulty in resisting high pay settlements in the private sector when public sector earnings growth and interest rates are both high."[19]

We warned that the corporate sector might have to bear a large proportion of the overall burden of adjustment required to meet the targets of the financial strategy. In "Economic Prospects" the Treasury's 1981 forecast of profits is limited to the following:-

> "Profit margins have declined very sharply in 1980: the prospect for next year is highly uncertain, but margins may not decline as much again".

We have previously stated and we reiterate that the Government must be prepared with measures to relieve what continues to be a "very damaging deficit".[20]

(f) Inflation

24. Inflation as measured by the RPI between the fourth quarter of 1979 and the fourth quarter of 1980 is likely to be 1 per cent lower than the Treasury's Budget forecast of 16½ per cent. The short-term rate is considerably lower and inflation appears to be decelerating rapidly.

25. This reduction in the inflation rate can be regarded as a success. However, as we shall discuss, it is not easy to relate this success to a close control of the money supply. Moreover, success has been achieved at the cost of a severe squeeze on profit margins, partly brought about by the increase in the exchange rate, and at a considerable cost in terms of lost output and jobs.

26. For the purposes of their forecast the Treasury assume that the current high level of the exchange rate will be maintained. If this turns out to be the case there will be no let up of pressure on the exporting sector which in 1981 may additionally be facing less buoyant markets than those of this year.

27. The Treasury's forecast that prices will rise by 11 per cent between the fourth quarter of 1980 and the fourth quarter of 1981 seems to be on the high side since, on the Treasury's own estimates, the underlying rate is already at about that level. The caution may however by justified since (as we have already said) the current reduced rate of inflation has been effectively achieved by a squeeze on profit margins. The Treasury suggests that the squeeze has taken "several percentage points" off the current level of retail and wholesale prices. If demand does recover next year it is possible that companies will respond by restoring margins. Pay pressures may also grow. We have heard nothing to relieve our fears that the current reduction in inflation will be reversed to some extent if and when the economy recovers.

(g) The Public Sector Borrowing Requirement

28. The PSBR in the first half of 1980-81 was £8 billion. This compares with the Budget forecast for the year as a whole of £8½ billion. The Treasury has provided only broad explanations for the over-run, and in response to a request from us for more detailed information did little more than repeat the material presented in 'Economic Prospects'.[21] There has been, according to the Treasury some overspending on defence, on agricultural support, and by the local authorities. Debt interest is now estimated to be £½ bn higher than earlier forecast, and costs in the public sector, particularly pay, have risen further relative to prices generally than was expected. In the absence of any detailed quantitative estimates the Committee find it impossible to make an adequate assessment of the reasons why the PSBR has so greatly exceeded the Budget forecast level. The matter merits further explanation. We shall be pressing for a detailed breakdown of the figures from the Treasury.

29. As noted above, nationalised industries have been particularly severly hit by the recession and their need for additional borrowing has contributed significantly to the rise in the PSBR.

30. In our Second Report we also questioned the Treasury's forecasts of the relative price effect which measures the difference between the rate at which costs in the public sector increase relative to inflation generally. We commented, "the cost of the Government's programmes in 1980-81 may be higher than that shown in the White Paper on account of the differential between the large increase in public sector pay compared with private sector pay for the 1980-81 financial year."[22] As far as we can tell from the figures provided so far this observation has proved well founded.

31. The revision of the forecast for the PSBR for 1980-81 from £8½ billion to £11½ billion understates the forecasting error since the new figure would be £650 million higher but for the reduction in the EC contribution which was not taken into account earlier. Thus so far there is an estimated error of £3.65 billion.

32. Paragraph 29 of 'Economic Prospects' states: "After taking account of the tax changes announced on 24 November, revenues from North Sea oil and gas in 1981-82 are expected to be in the range £4½-£5 billion, at 1980-81 prices, a little higher than forecast at the time of the Budget". Since the proposed tax changes were expected to raise around £1 billion in 1981-82 the Committee were puzzled by the reference to revenues only being "a little higher than forecast at the time of the Budget". We questioned the Treasury on this, and were told by the Chancellor[23] that oil production forecasts for 1981-82 had been revised somewhat downwards and capital expenditure (which attracts tax allowances) revised upwards. In the Treasury's view these two developments about cancel out the yield in 1981-82 which is expected from the tax changes. The Committee may well wish to examine the matter of oil revenues further.

33. The Treasury is understandably reticent about forecasting the PSBR for 1981-82 given the very large margins of error already revealed for the current year. "Economic Prospects" mentions a number of favourable factors for 1981-82: the fiscal measures of November 24th; the improved financial position of public corporations [sic]; and lower pay increases in the public sector" - all factors which may outweigh the continuing effects of the recession - and estimates that the PSBR may fall as a percentage of GDP, which may well be consistent with an increase in its absolute level.

34. We do not have adequate information to judge the validity of the Government's figures for 1981-82. The public expenditure changes announced on November 24th only listed the effects of policy changes; but in the past far larger changes have arisen from "estimating changes". The Treasury tells us that it cannot at present provide additional information for 1981-82. We find this surprising. The Treasury are also unable to give us an estimate of the out-turn for public spending in the current year.

(h) Public Sector Pay

35. In our Second Report we said we were not convinced that cash limits were fully effective in controlling public sector pay. We therefore intended pursuing the matter with the Chancellor.

36. This we did in our Fifth Report,[24] the Treasury's observations on which were published in our Third Special Report.[25] Briefly, we expressed our continuing concern about the way cash limits could be evaded by staging or delaying payment and by double counting, so far as the Civil Service was concerned, in taking credit when settling pay for reductions in numbers which would have taken place in any case. We were also concerned that the presentation of the split provision for Civil Service pay between the main departmental Estimates and the global Estimate for pay increases tended to cause confusion as the figures were not brought together in any one place.

37. The Treasury's observations seemed to show that the Committee had failed to convince the Treasury on these important points. We were therefore all the more pleased to learn from the Chancellor's letter of 24th November[26] that on further reflection the Chancellor had come to agree with the Committee particularly on the undesirability of staging and the need for provision of full information. The Committee welcome these developments and have set out their understanding of the present position in the Chairman's letter of 26th November.[27]

(i) The money supply

38. The annual rate of increase in sterling M3 - the key element in the government's medium-term financial strategy - was 24 per-cent during the period February to November. Other measures of money growth show smaller rises. (M1 has for example grown at an annual rate over the February-November period by around 8%, PSL 1 by around 20%.) The upper limit for £M3 was put at 11% for 1980/81. When this limit was announced it was recognised that the removal of the "corset" would involve some acceleration of monetary growth. Allowing for this, recent estimates by the Treasury put the annual growth of £M3 at 19%, well above the upper limit of the target range. Preliminary figures for November point to this annual rate rising to 20%. As recently as July 28th the Chancellor confirmed to us that he believed the money supply was probably under control.[28] £M3 is the target the Government has chosen to emphasise. We shall comment on the wisdom of this choice in our forthcoming report on monetary policy.

39. In their evidence to us on December 1st, Treasury officials provided four explanations for the rapid growth of sterling M3. The first was the effects of removal of the corset which had been much larger than expected. The second was the unexpectedly rapid growth of the PSBR. The third was the effects of external finance following the favourable movement in the current account of the balance of payments. The fourth

was the continued high level of bank lending. This list covers virtually all the possible sources of monetary growth and is tantamount to saying that the money supply has risen because the money supply has risen. It does not hide the fact that the Government has not achieved the one target to which it was absolutely committed.

40. "Economic Prospects" includes the following statement about monetary growth in the remainder of the financial year:

> "Thus the forecast of underlying monetary growth over the target period of February 1980 to April 1981 is that it will come back towards the top of the 7-11 per cent range".

Such a vague statement might simply mean that by next April the money supply could be growing at an annual rate of about 11 per cent; it implies nothing about the expected growth over the target period as a whole. This deliberate uncertainty was confirmed by Professor Burns' statement that he was not prepared to tell us what he thought monetary growth would be from now to the end of the fiscal year.[29] Professor Burns also remarked:

> " ... in fact there is very little that the Government can now do which would influence the rate of monetary growth between now and the end of the current target period. We are not in a position of taking further fiscal action which might do a great deal. Furthermore, any changes in interest rates are unlikely to do a lot between now and then".[30]

We have not been convinced that this is necessarily so. It is clear to us that there has been a suspension of the money supply numbers in the Medium Term Financial Strategy until the 1981 Budget, numbers the Government has said were central to its economic strategy.

41. In the November statement the Chancellor announced the reduction of MLR by two points, before any clear evidence of a decline in monetary growth was apparent. On December 1st officials explained this action to us in terms of a broader view of economic developments as a whole and also suggested that there was beginning to be a fall in corporate loan demand.

42. In his statement of November 24th, the Chancellor said that the Budget will be designed "to ensure that the thrust of the medium term financial strategy is maintained". We are not clear what this means.

43. We have expressed our reservations in the earlier paragraphs of this Report. We will be making a further report to the House at the time of the Budget. The Chancellor's statement of 24th November taken together with the Industry Act forecasts did not, of course, provide the full information that will be available at the time of the Budget and the next Public Expenditure White Paper.

Footnotes

1. "The Budgets and the Government's Expenditure Plans 1980-81 to 1983-84", HC(1979-90)584
2. Appendix 6
3. Appendix 7
4. "Economic Prospects to End-1981"
5. Q16
6. Economic Trends, November 1980; "British Business", Nov 28 1980
7. HC(1979-80)679-iii, Q 335
8. Annex 2 to oral evidence
9. Q 16
10. Q 114
11. HC(1979-80)679-vi, Q 655
12. Cmnd 8091
13. HC(1979-80)584
14. Q 44
15. Q 51
16. These cover 668,000 people (Secretary of State for Employment, Official Report, 9 December 1980, Col. 1172); according to the Department of Employment the effect on the unemployment register is of the order of 250-300,000 people.
17. HC(1979-80)584, paragraph 17
18. Q 31
19. HC(1979-80)584, paragraph 27
20. ibid., paragraph 29
21. Annex 1 to oral evidence
22. HC(1979-80)584, paragraph 21
23. Chancellor's letter of 11th December; Appendix 8
24. "Provision for Civil Service Pay Increases in the 1980-81 Estimates" HC(1979-80)730
25. HC(1979-80)819
26. Appendix 3
27. ibid
28. HC(1979-80)679-vi, Q 671
29. Q 76
30. Q 63

TABLE 1

FORECASTS FOR 1980 & 1981

	Budget	Industry Act November 1980		Margins of error	
	1980	1980	1981	1980[1]	1981[2]
GDP	-2½	-3	-1½	1	1½
Consumers expenditure	1	0	-½	1	1½
General government expenditure	-2	-1	-2	1½	1½
Other fixed investment	1	½	-4	3	4
Exports of goods and services	½	1	-3	2½	3½
Change in stockbuilding (as percent of GDP)	-2	-4	1	¾	1
Imports of goods and services	2½	-3	0	2	2½
Manufacturing output	-4½	-10	-4	4	
Balance of payments current account £ billion	-2¾	2	2		2
Retail price index (4th quarter 1979 to 4th quarter 1980)	16½	15½	11	2½	3
Public sector borrowing requirement (Financial year 1980-81) £ billion	(8)[3] 8½	11½		3	

[1] as estimated in Budget Forecast
[2] as estimated in Industry Act forecast, November 1980
[3] adjusted for E.C. refund